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Venice Economic Summit: Outlook for Economic Policy Coordination Issues

Summary

The non-US, Big Six Summit participants continue to be driven by domestic, rather than international considerations in setting their strategies for economic policy coordination discussions. At Venice, all will urge the United States to cut the fiscal deficit in order to reduce domestic demand and thus reduce the large current account imbalances facing the major countries. There will also be pressure on Japan and West Germany to ease their fiscal policies but they remain reluctant to go beyond changes already announced. Because there is little hope for agreement on a coordinated package of policy changes that would reduce imbalances, the Summit leaders could emerge from their discussions at Venice facing more exchange market volatility, increased pressures for protectionism, and even bleaker prospects for growth and employment. [redacted] 25X1

A series of simulations [redacted] 25X1 indicate that a combination of US fiscal restraint, West German and Japanese fiscal expansion, and further appreciation of the mark and yen could substantially reduce these three countries' imbalances without worsening the current accounts of other Summit countries or inducing recession. None of these developments alone would reduce all of the trade imbalances and some by themselves would stall growth or reignite inflation. [redacted] 25X1

This memorandum was prepared by [redacted] the Office of European analysis, with contributions from country analysts also from that office and [redacted] Comments and queries are welcome and may be addressed to the Chief, Issues and Applications Division [redacted] 25X1 25X1 25X1

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Our analysis indicates that unless some kind of coordinated approach is agreed upon, further dollar depreciation is likely. Although the West German surplus will probably trend down under current G-7 economic policies, the US and Japanese imbalances will not fall to what we believe are sustainable levels. Growth throughout Western Europe and Japan would be substantially lower as a result of renewed dollar weakness because of the negative impact on exports and business confidence. Declining growth prospects would strengthen the positions of those advocating expansion in Japan and West Germany and could lead to fiscal relaxation in both. 25X1

The prospects are poor for agreement at Venice on more binding policy coordination procedures. The West Germans, Japanese, and British in particular will almost certainly reject any proposals -- including those based on economic indicators -- which would limit their policy autonomy. We expect continued Big Six support for joint central bank intervention to stabilize exchange rates, a policy, however, the member countries view as effective only in the short run. 25X1

Because of mounting West European irritation over growing bilateral trade deficits with Japan, Tokyo runs the risk of becoming isolated in policy coordination discussions. We do not believe, however, that Japan will offer any more than piecemeal trade concessions. The perception in exchange markets of a generally acrimonious, anti-Japan Summit would probably hasten the yen's appreciation. Beyond the Summit the Japanese may react to Western European criticism by increasingly turning to bilateral discussions with the United States on substantive policy issues. 25X1

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The Policy Coordination Setting

The major economic imbalances now facing the Summit countries are potentially more threatening than the problems they faced earlier in the decade. In response to the emergence of huge fiscal and current account imbalances, the procedures for coordinating their economic policies have been strengthened over the last two years, but the governments generally have not yet attacked the imbalances in a coordinated way. Instead, non-US Summit country macroeconomic policy changes have been largely a reaction to domestic and currency market developments (see Text Box 1). 25X1

Recent Policy Changes

The Summit countries made good progress in dealing with the problems of unemployment, inflation, high interest rates, and sluggish growth that they faced in the early 1980s. Prior to the Tokyo Summit, inflation and interest

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Text Box 1

Economic Policy Coordination: Key Developments During the Decline of the Dollar

1985

February — The dollar peaks at 263 yen and 3.47 deutsche marks ... private market and central bank sales precipitate dollar decline ... foreign reaction is positive.

September — G-5 Plaza Accord ... citing US trade deficit and protectionist pressures, G-5 agree orderly dollar decline is desireable ... dollar falls nearly 8 percent against yen and mark the following week ... marks G-5 unanimity on exchange rates.

December — Dollar finishes year at 200 yen and 2.46 marks, 24 percent below peak against yen, 29 percent lower against mark, and 12 percent down on real, trade-weighted basis.*

1986

March — Coordinated half-percentage point cuts in US, Japanese, and West German central bank discount rates ... high-water mark of active policy coordination.

May — Tokyo Economic Summit ... "objective" economic indicators cited for study as foundation of policy coordination, intended to de-politicize and focus discussions ... G-7 created ... preceded by half-point cuts in US and Japanese discount rates ... raises profile of policy coordination efforts, but no fundamental policy changes announced.

September — G-5/G-7 meeting ... non-US countries maintain united front against further dollar decline and insist on US fiscal restraint ... Japan and West Germany refuse to cut discount rates ... signals lack of G-5 consensus on policies for reducing external imbalances.

October — US-Japan agreement to stabilize dollar-yen exchange rate ... Japanese government promises supplemental budget ... Bank of Japan cuts discount rate ... dollar firms against yen but slides against mark through late December ... greeted cautiously in Western Europe.

December — Dollar finishes year at 159 yen and 1.94 marks, down from peak 40 percent against yen, 44 percent against mark, and 20 percent on real trade-weighted basis.*

1987

January — Sharp dollar decline triggered by unexpectedly large US trade deficit and perception that US officials seeking lower dollar ... induces EMS realignment and half-percentage point cut in West German discount rate ... dollar stabilized by expectations of G-5 action.

February — G-6 Louvre Accord ... Italy boycotts G-7 meeting but others agree to resist "further substantial shifts among their currencies" ... touted as the successor to Plaza ... re-establishment of consensus on exchange rates.

March-April — Markets shrug off Louvre ... perceive growing US-Japanese tension and doubt US willingness to intervene ... yen appreciates sharply.

April — G-5/G-7 meetings reaffirm commitment to halt dollar's slide ... G-5/G-7 role controversy resolved but markets disappointed by lack of concrete policy changes ... dollar falls below 140 yen and 1.80 marks late in month ... intervention fails to support exchange rates.

*Morgan Gaurantee Trust trade-weighted real exchange rate against 18 industrialized and 22 developing countries.

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rates were reduced and the growth of unemployment was halted on average in the seven major countries. However, incompatible fiscal programs in the Big Three -- the United States cut tax rates and boosted spending while the West Germans and Japanese chose fiscal contraction -- led to large US, West German, and Japanese trade imbalances (see Table 1). The fiscally-driven surge in US growth in 1983 and 1984 and the extraordinary real appreciation of the US dollar caused large US trade deficits, permitting West Germany and Japan to tighten their fiscal positions while still boosting GNP in large part through exports to the United States. [redacted] 25X1

Officials in other Summit countries believe the Plaza accord in September 1985, which officially sanctioned the dollar's decline, marked a turning point in multilateral policy coordination. The dollar's decline had already begun in early 1985, precipitated by private market and foreign central bank dollar sales (see Figure 1). Most foreign officials viewed Plaza as a stop-gap measure to help maintain order in the foreign exchange markets until more fundamental changes in exchange rate policies could be agreed upon at the 1986 Tokyo Economic Summit. [redacted] 25X1

The Tokyo Summit did not forge a consensus on policy changes, but instead focused on strengthening the coordination system itself by seeking to depoliticize it, make it more disciplined, and base it on an improved analytical framework. The two specific achievements at Tokyo -- establishment of the G-7 and agreement to develop a set of "objective indicators" -- have led to consensus on some issues and friction on others. While all foreign Summit governments agree that use of indicators will aid policy discussions, they differ over their potential for guiding policy in part because of disagreement on how the adjustment burden should be divided between deficit and surplus countries. Though careful to avoid the "fine-tuning" label, the French are seeking a relatively activist system in which each country's economic policies could be influenced by the indicators. The West Germans, Japanese, and British, in contrast, want indicators to serve merely as a basis for consultations and want no automatic triggers or ties between trends in the indicators and policy responses. [redacted] 25X1

<u>The Economic Outlook Heading into Venice</u>

The same problems that motivated the push to strengthen policy coordination at Tokyo haunt the Venice Summit:

-- The US fiscal and current account deficits remain high with observers forecasting only small reductions at best through 1988.

-- The West German and Japanese current accounts this year will remain near their 1986 levels in dollar terms. [redacted] 25X1

Economic growth in 1987 for the other six Summit countries will average about 2.5 percent, the same as in 1986, but prospects for certain countries are worsening. In particular, the widely predicted 2.7 percent growth for Japan this year is now less likely because these forecasts were based on the yen remaining above 150 to the dollar. At current exchange rates, [redacted] 25X1

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Table 1

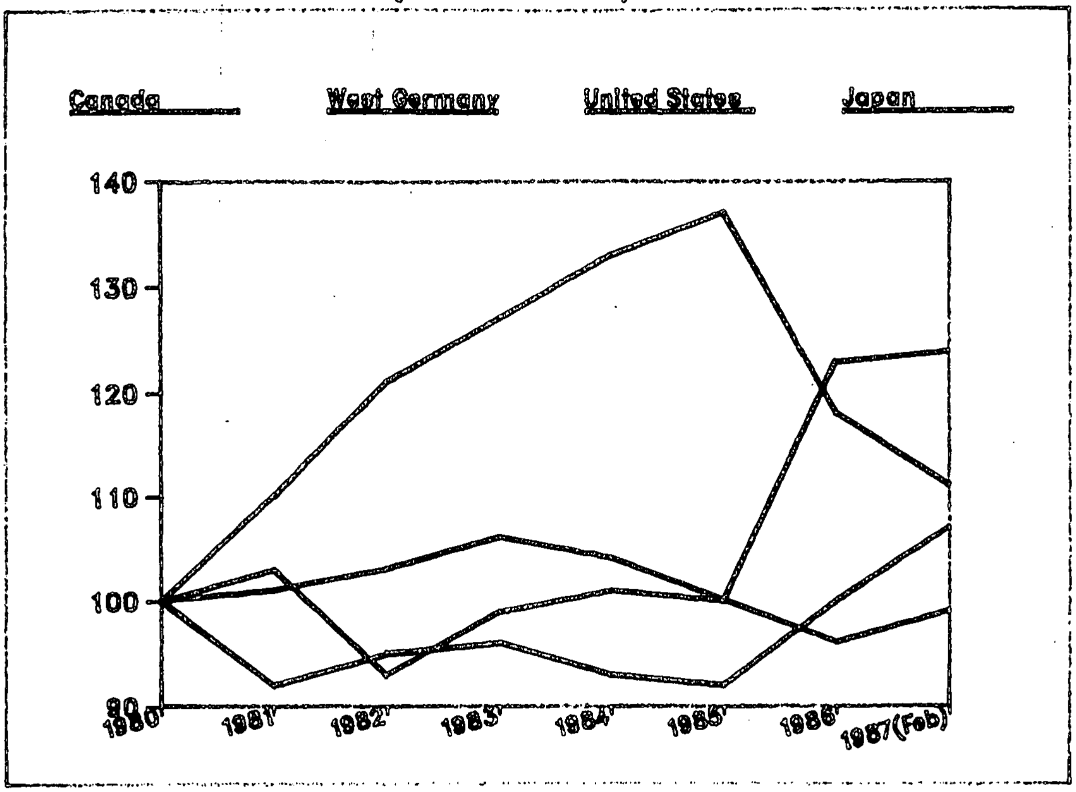
Summit Countries: Trends in Key Economic Indicators

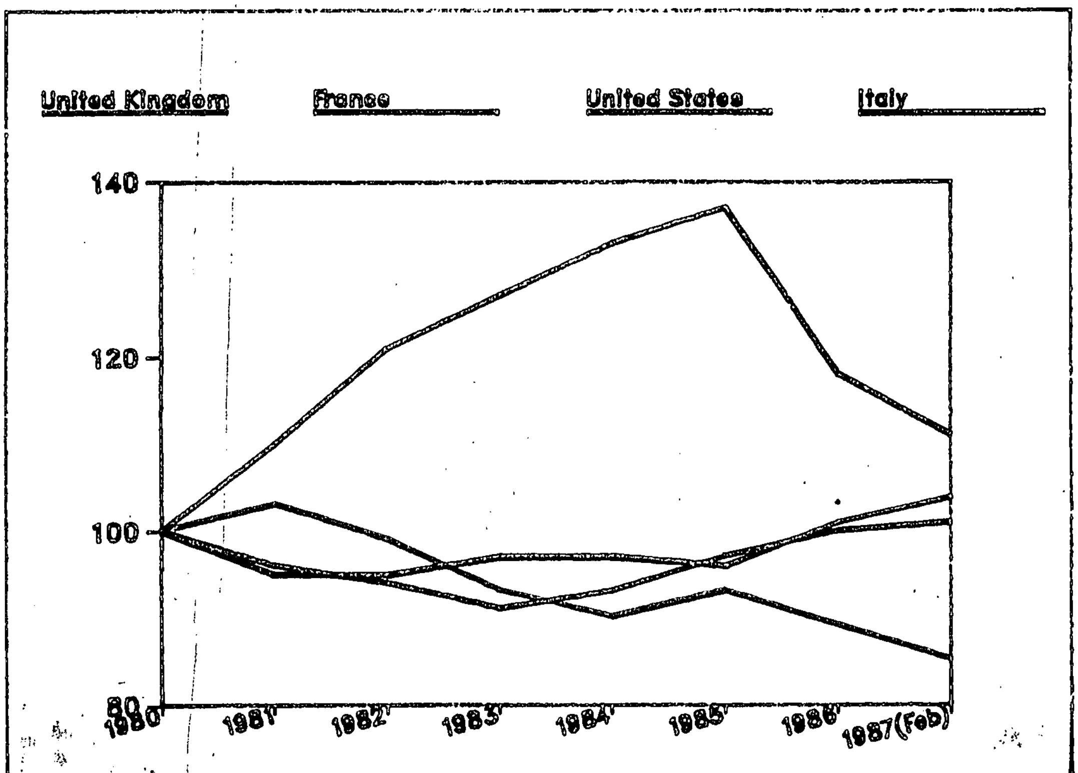
	1980	1981	1982	1983	1984	1985	1986
Real GDP Growth: G-7	1.1	1.6	-0.6	2.8	5.0	3.0	2.5
United States (GNP)	-0.2	1.9	-2.5	3.6	6.4	2.7	2.5
Japan (GNP)	4.3	3.7	3.1	3.2	5.1	4.7	2.3
West Germany (GNP)	1.5	0.0	-1.0	1.8	3.0	2.5	2.4
France	1.1	0.5	1.8	0.7	1.5	1.4	2.0
United Kingdom	-2.3	-1.2	1.5	3.5	2.7	3.5	2.3
Italy	3.9	0.2	-0.5	-0.2	2.8	2.3	2.8
Canada	1.5	3.7	-3.3	3.1	5.5	4.0	3.4
Inflation (CPI): G-7	12.0	9.9	7.0	4.4	4.4	3.8	1.9
United States	13.5	10.3	6.2	3.2	4.3	3.6	1.9
Japan	7.8	4.9	2.7	1.9	2.3	2.0	0.6
West Germany	5.4	5.3	4.8	2.6	2.1	1.7	-0.1
France	13.3	13.3	12.0	9.5	7.7	5.8	2.5
United Kingdom	18.0	11.9	8.6	4.6	5.0	6.1	3.4
Italy	21.2	19.3	16.4	14.9	10.6	8.6	6.1
Canada	10.2	12.5	10.8	5.8	4.3	4.0	4.2
Unemployment Rate: G-7	5.6	6.5	8.0	8.2	7.5	7.4	7.4
United States	7.2	7.6	9.7	9.6	7.5	7.2	7.0
Japan	2.0	2.2	2.4	2.7	2.7	2.6	2.8
West Germany	3.4	4.9	6.8	8.2	8.1	8.2	7.9
France	6.6	7.7	8.4	8.6	10.0	10.4	10.7
United Kingdom	6.5	10.1	11.8	11.3	11.1	11.3	11.6
Italy	7.6	8.4	9.1	9.9	10.4	10.6	11.1
Canada	7.5	7.5	11.1	11.9	11.3	10.5	9.7
General Government Deficit to GNP Ratio: G-7	-2.5	-2.6	-3.9	-4.1	-3.4	-3.4	-3.2
United States	-1.3	-1.0	-3.5	-3.8	-2.9	-3.5	-3.4
Japan	-4.4	-3.5	-3.6	-3.7	-2.1	-1.0	-1.1
West Germany	-2.9	-3.7	-3.3	-2.5	-1.9	-1.1	-1.1
France	0.2	-1.8	-2.7	-3.1	-2.9	-2.6	-2.9
United Kingdom	-3.5	-2.8	-2.3	-3.7	-3.9	-2.8	-3.2
Italy	-8.0	-11.0	-12.9	-14.0	-13.2	-13.7	-12.1
Canada	-2.8	-1.5	-5.7	-6.6	-6.6	-6.6	-5.4
Current Account to GNP Ratio							
United States	0.1	0.2	-0.3	-1.4	-2.2	-2.9	-3.3
Japan	-1.0	0.4	0.6	1.8	2.8	3.7	4.4
West Germany	-1.9	-0.7	0.6	0.6	1.1	2.2	4.0
France	-0.6	-0.8	-2.2	-1.0	-0.8	0.0	0.5
United Kingdom	1.4	2.5	1.4	1.0	0.4	1.0	0.0
Italy	-2.5	-2.5	-1.7	0.2	-0.8	-1.2	0.9
Canada	-0.4	-1.5	0.8	0.7	0.8	-0.1	-1.8
Interest Rates*							
United States	11.6	14.1	10.7	8.6	9.6	7.5	6.0
Japan	10.9	7.4	6.9	6.4	6.1	6.5	4.8
West Germany	7.8	10.4	7.7	5.7	5.6	4.9	3.9
France	12.0	15.3	14.9	12.5	11.7	9.9	7.7
United Kingdom	15.1	13.0	11.5	9.6	9.3	11.6	10.4
Italy	15.9	19.3	10.2	17.8	15.3	13.9	11.1
Canada	12.8	17.7	13.6	9.3	11.1	9.4	9.0

*Short-term money market rates in Japan and France, Treasury bill rates in others.

Figure 1

Summit Countries: Real Trade-Weighted Exchange Rates* (1980 = 100)





*Source: Based on Morgan Guaranty Trust trade-weighted real exchange rates against 18 industrialized and 22 developing countries.

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[redacted] the Japanese economy could slip into a recession late this year. Japanese fiscal stimulus plans will probably not be settled until the fall and will come too late in the year to offset any further rise of the yen. [redacted] 25X1 25X1

The outlook for West Germany now is also gloomier than it was just a few months ago. The five leading West German economic institutes for example, recently revised downward their 1987 growth forecasts from an average 3.0 percent made last October to 1.7 percent. Poor export performance and declining business confidence are primarily responsible for the change in outlook. [redacted] 25X1

The French economy will probably grow less than 2 percent this year as a result of sluggish consumer and government demand. Both the UK and Italy are expecting more robust -- up to 3 percent -- growth this year; private consumption and investment in both are fueling the expansion. [redacted] 25X1

The major threat to Big Six growth is the further decline of the dollar. Growth throughout Western Europe and Japan would be substantially lower as a result of renewed dollar weakness because of the negative impact on exports and business confidence. [redacted] 25X1

<u>Alternatives to Reducing the Economic Imbalances</u>

In order to reduce the huge current account imbalances without one or more of the major countries experiencing a recession, we believe a complementary set of policy changes are needed. [redacted] 25X1 [redacted] one feasible approach to reducing the economic imbalances 25X1 among the Summit countries without a major negative impact on growth includes a combination of yen, and to a lesser degree, mark appreciation, moderate economic stimulation in Western Europe, substantial fiscal expansion in Japan, and sustained gradual cuts in the US fiscal deficit.* [redacted] 25X1

Any one of those changes alone either would not reduce the current account imbalances significantly, or would induce a recession somewhere in the Summit countries. Our simulations also strongly suggest that over the medium to long term the trade imbalances are primarily a US-Japan problem. Even barring mark appreciation, with moderate growth in the West German economy, we expect Bonn's surplus to trend down. [redacted] 25X1

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* We do not think monetary policy can play a major role in the adjustment process. The dangers raised by an increase in dollar interest rates to a world economy heavily burdened with dollar-denominated debt suggest that the role for US monetary policy is limited. Similarly, with the Japanese economy awash in liquidity, further monetary easing is not likely to have a sustained effect on Japanese demand. While we do not believe any econometric model can predict the short run results of policy changes with pinpoint accuracy, we do believe [redacted] 25X1 [redacted] sufficiently reliable ball-park estimates to enable us to 25X1 separate adjustment packages likely to succeed from those likely to fail. [redacted] 25X1 [redacted] 25X1

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Baseline Scenario

To assess the impact of various policy alternatives, we first estimated how the current account balances of the major countries would evolve in the absence of policy or exchange rate changes. <u>This "baseline" scenario is not our forecast of summit country current accounts and real growth, but rather a projection of recent economic trends</u>. Indeed, we believe the baseline is not sustainable. The baseline, therefore, serves to draw out the implications of current trends and the apparent need for policy changes, and as a standard against which to assess the likely impact of various policy combinations. For the 1987-1990 baseline we assumed:

-- Real GNP growth averages 3.5 percent annually in Japan and 2.5 percent annually in the rest of the OECD.

-- Real exchange rates remain unchanged after April 1987; nominal rates change just enough to offset differentials in inflation rates.

-- Oil prices average $16.75 a barrel in 1987 and stay constant in real terms through 1990. Fuel import volume rises 2.0 percent annually from 1985 levels in the net fuel importing Summit countries, while Canada's net fuel exports rise and the UK's fall by small amounts.

-- Foreign exporters -- who on average raised export prices in 1986 by only 50 percent of the amount required to offset currency appreciation -- do not try to restore profit margins during 1987-1990.

-- West Germany goes through with its planned 14 billion mark tax cut in 1988 and Japan implements its proposed 5 trillion yen fiscal stimulation package. [redacted] 25X1

Under this baseline, the US current account improves in 1988 but worsens after that primarily for two reasons: (1) the balance on investment income plunges from an estimated $23 billion surplus in 1986 to a $25 billion deficit in 1990, and (2) the fuels deficit worsens steadily from $29 billion in 1986 to $38 billion in 1990 (see Table 2). The US bilateral deficit with Japan declines to about $30 billion while Japan's overall surplus initially falls because of an increase in the oil import bill, then begins rising again after 1988. Japanese net exports of non-fuel goods shrink in real and in yen terms. In dollar terms, imports grow at a much more rapid rate than exports but, because the starting imbalance is so great, the surplus continues to grow. Also, Japan's surplus on investment income increases from roughly $8 billion in 1986 to $19 billion in 1990. [redacted] 25X1

The West German surplus temporarily jumps in 1987 because real GDP growth is only 1.5 percent. The surplus, however, would rise less in 1987 and fall more in subsequent years should actual 1987 growth prove higher, as three of the West German institutes are predicting. The bilateral trade surplus with the United States all but vanishes by 1990. [redacted] 25X1

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Table 2

Summit Countries: Baseline Projections of Current Account Balances*

(billions US $)

	1986	1987	1988	1989	1990
United States	-141	-144	-143	-156	-180
Japan	82	71	67	73	86
West Germany	36	43	32	24	24
France	4	1	-2	-4	-1
United Kingdom	0	-3	-5	-9	-12
Italy	5	-4	-9	-11	-12
Canada	-7	-3	-4	-6	-8

* These baseline projections are not forecasts. They assume that the real exchange rates and government policies in place or planned in late April are unchanged.

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The UK and Italy are the only other two countries which experience a significant change in current account balances in the baseline scenario. Italy's shift from a surplus to deficit country occurs mostly because of the increase in its fuel bill. The UK shifts from balance in 1986 to a $12 billion deficit in 1990 in part because of an assumed continued loss of world market share, but primarily because a relatively large portion of British exports go to areas which have experienced depreciating currencies -- the United States and LDCs. [redacted] 25X1

Scenario 1: A coordinated approach involving currency rate adjustments, fiscal easing in the Big Six, and US fiscal restraint.

Our model indicates that a coordinated adjustment package involving the United States, Japan, and West Germany rids the major economies of the serious imbalances implied by the baseline case without inflicting major economic hardship on any Big Six country (see Table 3). For this scenario we assumed:

-- The Japanese yen and West German mark appreciate 20 and 10 percent respectively against all other currencies in real terms.*

-- All non-US Summit countries modify their fiscal policies to sustain baseline real GNP growth; this requires substantial fiscal easing in Japan and West Germany.

-- The United States restrains fiscal policy and keeps real GNP growth 1 percentage point below the baseline at 1.5 percent. [redacted] 25X1

This combination of policies and exchange rates quickly reduces the US and Japanese trade imbalances sharply by 1990 and restrains the build-up of US net foreign debt and Japanese net foreign assets. The West German surplus nearly vanishes while the balances of the other Summit countries collectively change little. We also estimate the US unemployment rate would hover around its current level, remaining 2.1 percentage points above baseline in 1990. Stimulation of domestic demand in West Germany and Japan would help offset the negative impact on both countries of lower US growth, allowing the Summit countries collectively to grow at an average rate of 2.3 percent. The US general government fiscal deficit ratio would fall steadily to zero percent by 1990 while the Japanese ratio would rise to 4.8 percent, and the West German ratio to 2.6 percent. [redacted] 25X1

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*An acceptable adjustment package appears to require that the mark and yen rise against both the dollar and the other Summit country currencies. If instead the dollar depreciates uniformly against all currencies, leaving the mark unchanged within the EMS, the Western European Summit countries and Canada would all develop unsustainable current account deficits without greatly reducing the West German surplus. [redacted] 25X1

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Table 3

Scenario 1: 10 percent real mark appreciation, 20 percent real yen appreciation, non-US summit countries stimulate domestic demand to maintain baseline GNP growth, US restrains demand by cutting fiscal deficit.

	United States		Japan		West Germany		Other Summit	
	Level	Change from Baseline	Level	Change from Baseline	Level	Change from Baseline	Level	Change from Baseline
Current Account (billions US $)								
1987	-129	15	64	-7	44	3	-11	-2
1988	-100	43	32	-35	23	-11	-20	0
1989	-84	72	20	-53	8	-16	-30	0
1990	-72	108	20	-66	3	-21	-39	-6
Real GNP Growth (percent)								
1987	2.0	-1.0	3.0	0	1.5	0	2.6	0
1988	2.0	-1.0	3.5	0	2.0	0	2.4	0
1989	1.5	-1.0	3.8	0	2.8	0	2.5	0
1990	1.5	-1.0	3.8	0	2.8	0	2.5	0
Unemployment (percent)								
1987	6.5	0.4	3.5	-0.1	7.9	0	11.4	0.2
1988	6.3	1.0	3.6	-0.1	8.0	0	11.6	0
1989	6.4	1.5	3.6	-0.2	7.9	0	11.7	-0.1
1990	6.7	2.1	3.7	-0.2	7.7	0	11.8	-0.1
Inflation (percent)								
1987	2.7	-0.3	-0.6	-0.6	0.1	-0.6	3.9	0.6
1988	2.4	-0.6	0.6	-0.4	1.5	-0.5	4.4	0.7
1989	3.0	-1.0	1.8	-0.2	1.8	-0.2	4.9	0.7
1990	2.8	-1.2	1.9	-0.1	1.9	-0.1	5.0	0.8

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Other Scenarios

Less comprehensive adjustment packages would have a far smaller impact on the current account imbalances. Moreover, in some cases they produce results that would likely erode the policy coordination process and prove highly objectionable to some governments. All of the following scenarios leave the US current account deficit well above $100 billion by 1990, and rising. Each includes some, but not all of the elements of Scenario 1 (see Table 4): 25X1

-- Scenario 2: 10 percent real mark and 20 percent real yen appreciation against all currencies, and non-US fiscal expansion to sustain baseline growth (Scenario 1 without US fiscal restraint). We believe this simulation helps to highlight the importance of US demand restraint in reducing the imbalances. Under this scenario the Japanese and West German surpluses would be greatly reduced, but because US growth picks up the US deficit is not much improved. The Japanese and West German fiscal deficit ratios would rise to 4.4 and 2.1 percent of GNP respectively. 25X1

-- Scenario 3: 30 percent real dollar depreciation. We believe this simulation illustrates the ineffectiveness of relying solely on exchange rates for adjustment. Under this scenario the US deficit would be only slightly reduced. Higher growth in the United States and a high US propensity to import combine with poorer growth in US export markets to largely offset the positive effects of cheaper dollars on US exports. Also, because of growth differentials -- and because of the new nominal currency rates -- the Japanese and West German surpluses would rise in dollar terms, although both would fall in real and national currency terms. We calculate non-US OECD growth would be nil in 1987 and 1988 -- Japan and France would be in recession in 1987 -- and also that US inflation would hit 7 percent by 1989. 25X1

-- Scenario 4: 30 percent dollar depreciation plus fiscally-boosted growth 1 percentage point above baseline in the non-US Summit countries. We believe this simulation demonstrates that even a broader-based adjustment package is inadequate if it omits US demand restraint. Under this scenario, faster Big Six growth would complement the dollar depreciation but because US growth is not restrained, the US current account deficit would remain above $100 billion. The Japanese surplus would be sustained by buoyant West European imports, though in yen terms it would settle well below the 1986 level. The West German surplus measured in dollars would fall only modestly and the other Summit countries would develop very large current account deficits. We also calculate the US economy would overheat with inflation hitting 9 percent. 25X1

-- Scenario 5: Fiscally boosted growth 1 percentage point above the baseline in the non-US Summit countries. We believe this simulation highlights the importance of exchange rate realignments, particularly yen appreciation. Under this scenario the reduction of the US and Japanese imbalances would be extremely small because of the limited US-EC trade relationship and the extremely low Japanese import propensity. The European Summit countries

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Table 4

Other Scenarios: Effects of Alternative Adjustment Packages on the US, West German, Japanese, and Other Summit Country Current Accounts, (billions US $).

	United States		Japan		West Germany		Other Summit	
	Level	Change from Baseline	Level	Change from Baseline	Level	Change from Baseline	Level	Change from Baseline
Scenario 2: 10 percent mark and and 20 percent yen appreciation, non-US countries maintain baseline growth.								
1987	-146	-2	67	-4	46	3	-7	2
1988	-142	1	40	-27	27	-5	-11	9
1989	-154	2	32	-41	14	-10	-15	15
1990	-177	3	36	-50	12	-12	-17	16
Scenario 3: 30 percent dollar depreciation.								
1987	-156	-8	80	9	62	19	-2	-7
1988	-125	18	71	4	60	28	-32	-12
1989	-122	34	78	5	53	29	-61	-31
1990	-144	36	98	12	57	33	-73	-40
Scenario 4: 30 percent dollar depreciation and faster non-US growth.								
1987	-149	-5	72	1	57	13	-22	-13
1988	-110	35	51	-16	47	15	-83	-63
1989	-99	57	49	-24	32	8	-145	-115
1990	-116	64	58	-28	28	4	-190	-157
Scenario 5: Faster growth in non-US summit countries.								
1987	-142	2	70	-1	40	-3	-16	-7
1988	-139	4	64	-3	27	-5	-35	-15
1989	-150	6	68	-5	14	-10	-53	-23
1990	-172	8	79	-7	9	-15	-69	-36
Scenario 6: Severe US fiscal restraint in 1987 and 1988.								
1987	-122	22	67	-4	41	-2	-11	-2
1988	-99	44	57	-10	30	-2	-25	-5
1989	-103	53	59	-14	22	-2	-37	-7
1990	-111	69	68	-18	21	-3	-43	-10

[redacted] 25X1

would experience a modest deterioration of their external balances, while the US economy would not be strongly affected. [redacted] 25X1

-- Scenario 6: Extreme fiscal restraint holds US growth 2 percentage points below baseline in 1987 and 1988. We believe this simulation illustrates the inadequacy on the one hand, and potential dangers on the other, of a strong US response to foreign charges that the imbalances can be dealt with by a cut in US demand alone. Under this scenario, the rapid US fiscal deficit reduction to -0.3 percent of GNP in 1990 would reduce the US external imbalance by about $70 billion compared to the baseline. The Japanese surplus, however, would fall by only $18 billion, while the European Summit country current accounts would decline modestly. We believe these results may not convey the full risks associated with this scenario, however, because the contractionary effect of such rapid and severe US restraint would be compounded by a likely weakening of business confidence in the United States and elsewhere, including debt-ridden LDCs. [redacted] 25X1

Implications

It is likely the dollar will have to fall further -- particularly against the yen -- before Japan, and to a lesser extent West Germany, would significantly alter their fiscal policies. We believe that domestic concerns will continue to dominate economic policy discussions in the Big Six. Moreover, the Summit countries' refinement of policy coordination procedures probably will not be enough to generate any major changes at or before Venice. As a result, we believe the three major current account imbalances will not fall substantially this year -- and probably not in 1988 -- and that private investors will likely read the lack of major policy changes as a signal that further exchange rate changes are needed. We generally expect Big Six support at the Summit for joint central bank currency market intervention, but only as a stop-gap measure to help calm markets. Disputes among Summit countries over intervention policies are likely to grow if, as we expect, private investors bring new pressure to bear on exchange rates. [redacted] 25X1

With further currency appreciation in West Germany and Japan, the potential for economic stagnation would grow. Declining growth prospects would strengthen the positions of those advocating expansion in Japan and West Germany and could lead to fiscal relaxation in both; other Summit countries in West European would probably follow suit. There is a risk, however, which we do not consider high now, that the fiscal stimulus would not forestall West European and Japanese recessions. [redacted] 25X1

We believe a further substantial depreciation of the dollar would also precipitate protectionist reactions in Western Europe, impede any trade liberalization Japan was considering, and generally hinder GATT negotiations. Rising unemployment in Western Europe and Japan would compound these problems and also jeopardize medium run structural adjustment programs. LDC exports to these countries also would be hurt and debtors would likely raise new calls for an overhaul of the international monetary system. [redacted] 25X1

[redacted] 25X1

25X1

The propects for an agreement strenghtening the policy coordination procedures at Venice are poor. As long as the US fiscal and current account deficits persist, the West Germans, Japanese, and British will adamantly refuse to surrender any degree of policy autonomy. Specifically, they will almost certainly block any proposal for the prescriptive, rather than purely descriptive, use of economic indicators. Except possibly for the French, the Big Six probably would prefer to see Summit country policy coordination remain a non-binding search for consensus. 25X1

The dispute over Japanese trade policy and stimulation of their domestic economy is likely to be one of the key topics for policy coordination discussions at Venice. Prime Minister Nakasone will probably try to avoid criticism that Japan is still failing to accept its international responsibilities by fleshing out the proposed $34 billion stimulation package. We believe the dollar's decline would probably be hastened by perceptions of an essentially anti-Japan Summit. If after the Summit Tokyo still finds itself isolated and on the defensive, it would probably react by increasingly turning to bilateral discussions with the United States, while continuing to attend G-7/G-5 meetings. 25X1

25X1

[redacted] 25X1

APPENDIX

Country Priorities for Venice

The Big Six are all approaching the Venice Summit with the goal protecting their short-term interests rather than devising a medium-term coordinated strategy. They will continue to pressure the United States to reduce domestic demand by cutting the fiscal deficit, arguing that a credible US commitment to fiscal restraint is needed to restore investor confidence in the dollar. But they are divided over the need for changes in their own policies. Bonn and Tokyo remain opposed to aggressive fiscal or monetary stimulation while the other four would like these two countries to ease their economic policies. French and Italian officials, in particular, believe that more buoyant West German demand is necessary before they stimulate their own economies. The EC Commission agrees, motivated in part by the belief that more vigourous growth within the Community is an essential prerequisite for achieving its goal of completing internal market reform measures by 1992. [redacted] 25X1

The West Europeans are increasingly irritated by their growing bilateral trade deficit with Japan and fear increased diversion of Japanese exports from US to Western Europe. Indeed the EC Commission recently proposed a contingency trade retaliation plan to head off this diversion. The West Europeans are likely to stress at the Summit that Japanese structural change and trade liberalization are essential complements to needed fiscal stimulation. [redacted] 25X1

On other key issues, we believe the Big Six at Venice will:

-- Reaffirm their commitment to stabilize exchange rates in the short run by coordinated central bank intervention.

-- Support the use of objective indicators to focus policy coordination discussions while rejecting any automatic link between indicators and policy changes.

-- Affirm the status of the G-7 as the main forum for formal policy coordination discussions.

Beyond Venice, we believe West Germany and Japan increasingly will rely on less formal, non-public bilateral consultations with the United States to set policy coordination strategies, a move the French and British have feared since Tokyo. [redacted] 25X1

Japan

Tokyo's chief objectives at Venice will probably be to secure a strong G-7 commitment to restrain the yen -- in exchange for moving forward with its announced $34 billion stimulus package -- and to limit protectionist policies in the United States and Western Europe. Business leaders have begun to express serious alarm over the renewed yen appreciation, and the political

[redacted] 25X1

[redacted] 25X1

leadership is now under increasing pressure to find an international accomodation that will stabilize the currency. The Japanese strongly believe that their trade surplus is largely the result of excessive private and public consumption in the United States and that US fiscal restraint is the single most important policy change needed. [redacted] 25X1

The Japanese government is deeply divided on the issue of domestic fiscal stimulus, with the Ministry of Finance staff firmly opposed to an aggressive fiscal easing to reduce their current account surplus. On the other hand, Finance Minister Miyazawa, and to a lesser extent Prime Minister Nakasone, have shown some flexibility. Tokyo will probably pursue fiscal expansion with its proposed $34 billion supplementary budget to be finalized in August or September. The size and method of financing -- both of which will determine its expansionary effects -- probably will not have been finalized before Venice. When growth propects improve, however, Tokyo is likely to return to fiscal austerity. [redacted] 25X1

Japan's political and bureaucratic leadership is extremely reluctant to expose domestic producers to greater foreign competition through trade liberalization at a time when Japanese unemployment is at a post-war high. Even on specific trade disputes that have only a small impact on the trade surplus, Tokyo is likely to be inflexible. [redacted] 25X1

[redacted] 25X6

West Germany

Bonn's primary policy coordination goal at Venice very likely will be to counter calls for German reflation by arguing that a reduction in the US budget deficit would provide a far larger contribution to world economic adjustment. The West Germans also probably will press Tokyo to live up to its committment to provide fiscal stimulus and liberalize trade. Despite these goals, however, Bonn does not believe that either the US or Japan has sufficient latitude to enact these policy changes. [redacted] 25X1

The West Germans will almost certainly not be willing to change their fiscal and monetary policies for the sake of reducing global trade imbalances. The Finance Ministry believes the 2.0-2.5 percent growth it expects is acceptable and that the imbalances are at bottom a US-Japan problem. Bonn's fiscal flexibility at Venice will be constrained by upcoming state elections [redacted] 25X1

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[redacted] 25X1

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[redacted] 25X6

France

Paris's major policy coordination objective probably will be to formalize and strengthen the G-7 commitment to stabilize exchange rates among the world's major currencies, which the French see as a prerequisite to stable EMS exchange rates. They would like to see West Germany and Japan reflate but will probably defer to Washington during discussions of how to reduce the major trade imbalances. [redacted] 25X1

In the absence of greater West German growth, the French government is not likely to significantly boost domestic demand. A debate is beginning, however, over the need for mildly stimulative measures to improve the rather bleak economic outlook before next year's presidential election. So far, Prime Minister Chirac and Finance Minister Balladur have resisted, fearing a loss of government credibility. [redacted] 25X1

Paris remains enthusiastic about the use of economic indicators to guide policy coordination but will probably not push for an agreement at Venice linking movements in indicators to changes in Summit country economic policies. [redacted] 25X1

United Kingdom

London will probably focus on Japanese trade and fiscal policies as the principal barrier to correcting the major current account imbalances. Nonetheless, the British continue to believe that the US fiscal deficit must be reduced and that some West German stimulation is needed. They will, however, probably avoid criticizing Bonn in order to maintain a solid EC front. [redacted] 25X1

British fiscal and monetary policies will not likely change in the short term. The current goal is to get the Conservatives reelected later this year and the economy's "mini boom" has lessened the need for pre-election pump-priming. [redacted] 25X1

Chancellor of the Exchequer Lawson is optimistic that a limited degree of international economic cooperation can bring about a period of exchange rate stability, but believes indicators should only be used as a common basis for measuring economic trends. London will almost certainly oppose their use to dictate policy changes. [redacted] 25X1

Italy

Rome will probably be restrained in expressing views on reducing the current account imbalances at Venice because of its huge public sector deficit and high interest rates. Moreover, Italy's caretaker government faces an election on 14 June and thus probably will focus on staging a successful Summit. The Italians would, however, like to see a combination of more expansionary policies in West Germany and Japan and fiscal restraint in the United States. [redacted] 25X1

[redacted] 25X1

[redacted] 25X1

Rome probably will resist proposals for the use of indicators which infringe on their monetary options. In hopes of stabilizing EMS exchange rates, and thus strengthening its export sector, Rome will probably support efforts to stabilize the dollar-yen-ECU rates. Treasury Secretary Goria's comments to the press indicate that Rome is satisfied that the G-5/G-7 controversy has been settled in its favor by making the G-7 the principal forum for economic policy coordination. [redacted] 25X1

Canada

Ottawa will probably not attempt to play an important role in the policy coordination discussions at Venice. The Canadians would like to see exchange rates stabilized, but Finance Minister Wilson has publicly avoided a commitment to join official intervention. [redacted] 25X1

[redacted] 25X1